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Why Legal Terms Have Become a More Potent Ingredient in Buyout Bids

In the past several years buyout shops—when in pursuit of a target company—have been waiving certain legal rights to make their bids more attractive, according to a recent survey conducted by New York law firm Kaye Scholer, entitled "What's Market?". This phenomenon, deal pros say, is a direct consequence of sellers having the upper hand in today's private equity market, coupled with the need for buyers to somehow distinguish themselves from the rest of the pack.

"What's Market?", as the name suggests, was conducted to ferret out the typical—or "market"—legal structures agreed to in today's private equity arena.

"Legal contracts have certainly become another tool that firms are using to differentiate their bids," says John Baumer, a partner at Los Angeles-based Leonard Green & Partners. "And it's become increasingly more noticeable in the last year."

The survey tracked acquisitions of privately held businesses sponsored by private equity funds between Jan. 1, 2002 and Dec. 31, 2004. The data was compiled from Form S-4 documents filed with the SEC under Rule 144A.

Indemnity Caps

The most surprising data to emerge from the survey, says Derek Stoldt, a partner at Kaye Scholer, "was that there was a relatively high percentage of deals where there was no surviving indemnification for general claims, such as general breech of representations and warranties." Simply put, buyers use general indemnity to ensure that they actually get what they were told they were buying. If a rep or warranty has been breached, the general indemnity claim is the way the buyer is paid for the losses it has incurred. According to the survey, nearly a quarter of the private equity deals tracked had no claims on general indemnity.

Stoldt says that marks a major departure from seven to 10 years ago when it was common to see general indemnity claims "capped right at the purchase price." In the past several years, however, Stoldt says he's noticed fewer and fewer indemnification caps set that high, and according to the survey, only about 3.5 percent of the deals tracked had caps on indemnity equal to the purchase price, while the vast majority (70 percent) had caps set at less than the purchase price.

Although Peter Huff, a founder and general partner at Austin, Texas-based Blue Sage Capital, holds that it's never been common practice for his firm to seek indemnity caps as high as the purchase price, he too has noticed the diminished size of today's general indemnity caps. "It's definitely been coming down," he says. "The rule of thumb I used to use was about 10 percent of the purchase price, and that's come down in auction situations to about 5 percent to 7 percent."

The MAC Clause

Another legal issue that private equity players are tinkering with in their search for sell-side favorability is the MAC (material adverse change) clause, which protects buyers in instances when an outside event or development, such as an economic depression or an earthquake, threaten the target company financially or otherwise. According to the survey, more than 85 percent of deals that include MAC language included stipulations, known as carve-outs, to what firms can and cannot legally claim in the event of a materially adverse change in the company's performance.

"This is another place where they're probably conceding legal representation to appeal to the sellers," Stoldt says. Leonard Green's Baumer agrees, adding that tightening the MAC language of a contract "drives certainty" that the deal will close, which is more favorable to the seller.

The most common MAC concession that firms appear willing to make (occurring in 75 percent of the deals tracked by the survey) relates to "general economic or business conditions," and is followed closely by specific "industry conditions," which buy-side firms agree to part with 61 percent of the time.

On the flipside, deal pros seem to be least likely to give up MAC representation when it comes to "terrorism" (26 percent carve-out rate); "changes in GAAP" and "conditions arising out of changes in laws and or regulations" (both tied at 25 percent); and "acts of God, (i.e. natural disasters) which is only excluded from contract language 7 percent of the time.

Financing Out

Furthermore, the survey notes that 20 percent of LBOs did not include a "financing out" for the buyer, which means that in approximately one out of every five deals, private equity players are willing to shoulder the risk of financing the entire transaction themselves, if they are unable to secure an outside debt provider.

"Sellers want to sign an agreement that has as few outs for the buyer as possible, and the big out that's more in the control of the buyer than the seller is the financing out," says Stoldt. But even though 80 percent of the deals examined by Kaye Scholer included a financing out, Stoldt notes that impetus exists for that ratio to decrease as the market becomes even more competitive.

"As the hedge funds become more involved in the private equity space, you may see a decrease in the use of financing conditions," Stoldt says. "There's the chance that hedge funds will get comfortable financing the entire deal themselves—both buying the equity and supplying the debt—as a way of trying to stand out. And if they do that, then others will have to try and compete in some way, whether it's to try and do the same thing and take more risk, or to try and push one of other buttons available to them."

Legal Concessions

And as if the weight put on buyout shops to concede on specific legal issues, such as caps on escrow and survival of reps and warranties, were not enough, deal pros say they are sometimes asked to do so on a premature basis.

"We're finding that sellers with leverage—that is, sellers that have a good company that's in high demand—sometimes want clarity on the more significant legal terms earlier on in the process," says Leigh Randall, a principal at Roslyn, N.Y.-based Topspin Partners.

In Topspin's case, the decision to move forward in situations where emphasis is placed on speed depends largely on the overall terms of the deal. "If management is staying with the company after the acquisition, then usually we can be pretty comfortable discussing that stuff early on in the process, before diligence, but of course subject to diligence," Randall says. "But there are certainly some instances, like when we don't know the selling party well enough, or when management is not staying with the company post-close, when we are not as comfortable discussing legal terms that early on."

Indeed, most private equity pros interviewed for this article immediately brought up fiduciary responsibilities to limited partners and the importance of thorough due diligence when asked about the pressures of making legal concessions on the fly. And even though legal terms have certainly become a more potent element in the auction process, all agree that they are but one ingredient within a larger winning formula.

"Valuation used to be the key factor to winning an auction, and legal terms used to be a distant third or fourth cousin in the process," says Blue Sage's Huff. "Today, the winning factors are valuation, certainty to close and legal terms, so they definitely have become a more important aspect of the overall process."

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